A review by the **Federal Reserve Bank of Chicago**

Business Conditions

1961 June

Contents

THE Trend OF BUSINESS

In April and May the upswing in factory production gained momentum to an extent which had not generally been anticipated earlier. By the end of March there was little doubt that the economy had "bottomed out," but most observers had believed that recovery would come slowly. Now it appears that the uptrend, in its initial stages at least, may resemble the sharp revival of 1958 rather than the sluggish improvement from the low point in 1954.

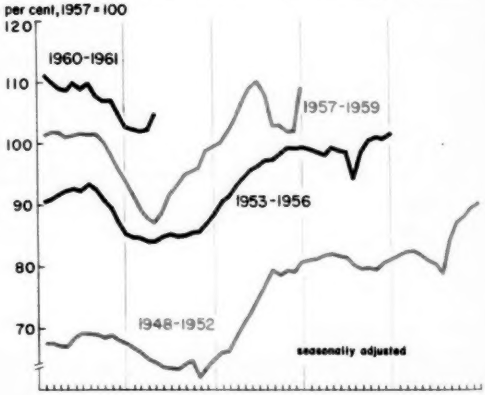
The recent surge in production and manufacturers' new orders is not based primarily upon an increase in sales of products to final users. Rather, the acceleration in the upswing stems largely from the same source as the 1960 decline in activity—a sharp change in business inventory policy. Most business managers apparently have concluded that inventory liquidation programs have been pursued far enough and, in many cases, that sales prospects justify higher inventories.

An important sustaining factor in the economy throughout the recession period has been Federal expenditures—cash payments to the public—which have been increasing continuously since the start of 1960. During the past six months Government spending, led by defense outlays, has risen at an accelerated pace and in the first quarter of 1961 was 1.6 billion dollars, or 7 per cent, higher than a year earlier.

Construction activity in the aggregate was well maintained during the recession, with a higher volume of Government projects largely offsetting a drop in private spending concentrated in housing. A large backlog of contracts for heavy construction, principally public works and public utilities, is likely to bring a rise in activity in the months ahead. However, thus far in 1961 the increase in construction activity has been only slightly more than seasonal. Nationally there is evidence of a pickup in housing starts, but this has not been apparent in the Midwest.

A vigorous business uptrend cannot be sustained for long on the basis of buying for inventory. In the absence of a huge, further increase in Government spending, not now in prospect, a substantial and sustained rise

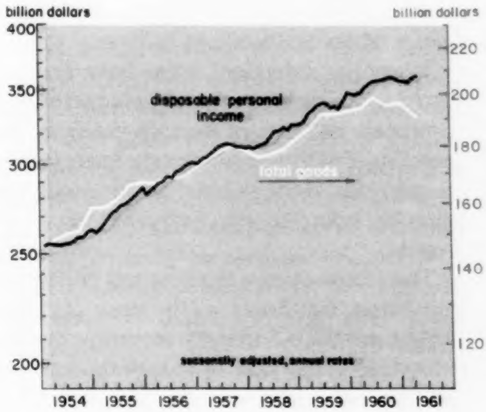
Industrial production rose in March and April following decline of about 7 per cent in preceding year



in business activity will depend upon an increase in plant and equipment outlays, housing and consumer buying of goods and services. Attention will be focused on the latter which accounts for about two-thirds of total output.

There has been no evidence of a strong rise in consumer expenditures thus far in 1961. In the first quarter, personal income, after taxes, was 3 per cent above the year-earlier level, but retail sales were down 1 per cent. April saw a further rise in income, but purchases of goods at retail declined slightly from the March level. In addition to higher income, a rise in purchases may be aided by consumers' holdings of liquid assets which have risen sharply and by the fact that installment debt has been reduced somewhat.

Consumer spending on goods lags relative to income



Industrial production spurts

In February the Federal Reserve's index slipped to 102 per cent of the 1957 average—the low point for production of factories, mines and utilities—and was 7 per cent below the level of the early summer of last year. With steel and autos leading the way, the index rose to 105 in April. Order trends suggest that the improvement continued in May.

Nearly 60 per cent of the membership of the National Association of Purchasing Agents reported an increase in new orders in April, compared with only 9 per cent who reported a decline. These figures mark a substantial improvement from the first quarter and are the most favorable in several years. In May new orders were rising in a wide variety of hard goods industries, including primary metals, electrical components, industrial equipment, construction machinery and household goods.

Along with higher production has come a steady, if modest, improvement in the job situation. In the first quarter most firms which increased production did so by increasing the average work week. During April, however, recalls and new hirings of production workers exceeded new layoffs. This trend has been noted by local employment offices in many Midwest centers.

Inventory reversal

Durable goods manufacturers reduced inventories by 400 million dollars in March, an acceleration of the liquidation of earlier months. However, the simultaneous move to increase production indicated that a substantial portion of the March reduction in inventories was not planned but resulted from a greater-than-expected rise in shipments.

Early in 1960 many business firms took steps to halt the rising trend of inventories. Strikes in steel and copper had been settled and virtually all types of materials and goods were readily available. Meanwhile sales fell short of expectations in a number of lines.

Business inventories were being increased at an annual rate of 11 billion dollars in the

first quarter of 1960. One year later, in the first quarter of 1961, inventories were being liquidated at a rate of 5 billion dollars, for an over-all swing in total demand from this source of about 16 billion dollars.

Inventory reductions have been concentrated in the purchased materials and goods-in-process holdings of durable goods manufacturing firms. Manufacturers have tended to maintain their finished goods stocks in order to compete effectively on rapid deliveries.

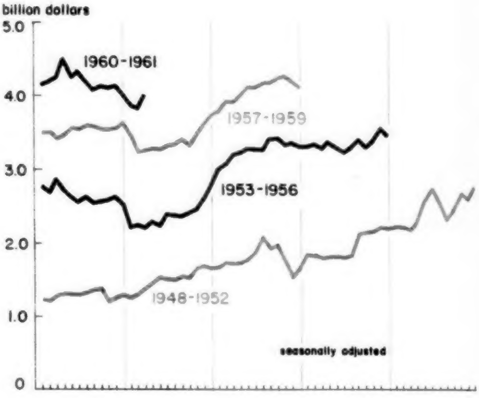
The recent change in inventory policy has been most significant in the area of "purchased materials," thereby reversing the development of last year. Although the increase in consumption of steel since last December has not been large, steel ingots and castings were being poured at a rate of over 100 million tons in May compared with only 65 million tons in the earlier month. Users of copper and aluminum also have increased their purchases of these metals. Prices of steel scrap and most nonferrous metals have firmed in recent months.

Retail sales lag

Since the second quarter of 1960 sales of durable goods stores, except for the temporary rise in auto deliveries in the late fall, have been at depressed levels. For the first four months of 1961 sales of all hard goods stores have been 10 per cent below the previous year. Between February and April there was a greater-than-seasonal rise in new car sales, but even in the latter month deliveries were running 17 per cent below the year-ago total. Sales of most other hard goods such as appliances, furniture and television also have been slow.

In contrast, total sales of soft goods, including food, clothing, gasoline and the like, traced a high, stable plateau throughout the

Instalment credit buying rose in March after declining somewhat from the 1960 peak



entire recession period. In the first four months of 1961 sales of nondurable goods stores were 2 per cent above the comparable period of 1960.

Consumers typically hold back on purchases which involve large individual outlays when they are uncertain about business conditions, especially when the purchase would involve going into debt. Under these conditions there is also a tendency to restrict buying of clothing. There is much less tendency to reduce expenditures on such important items of daily use as food and gasoline.

In the first quarter of 1961 consumers spent 54 per cent of their after-tax income on durable and nondurable goods combined; a year earlier this proportion was 56 per cent. But the smaller share of consumer income going for goods, as opposed to services or savings, is a recession development only in part. There has been a long-run trend away from goods during the postwar period as families—at least those with the necessary purchasing power—have become better sup-

plied with autos, housefurnishings, clothing and other items. In the early postwar years two-thirds of all disposable income was used to purchase goods. Expenditures for services, meanwhile, have risen in relative importance.

Personal income dropped less than 1 per cent during the recent recession, reaching a low in February. When consumers began to restrict their purchases of hard goods after mid-1960, savings, mainly in liquid assets but also in the form of debt repayment, rose more rapidly. In the first half of 1960 savings averaged less than 7 per cent of disposable income compared to 8 per cent since then.

Virtually all types of savings have gained from the reduction in consumption spending relative to income. In addition, short-term debt has been repaid. In the first quarter of 1961 outstanding instalment debt dropped by 2.1 billion dollars, a very large decline for this period of the year. During the same months new instalment credit extended was 8 per cent below last year.

Now that jobs and income have been rising and optimism is improving there is a prospect of a substantial increase in consumer spending. Clearly, consumers will be able to step up their purchases if they become optimistic as to employment and income prospects.

Depressed areas— some lessons from the past

Today a number of communities in the United States are confronted with the problem of "substantial and persistent unemployment." They have come to be known as chronically depressed areas. In the main these areas are located in the coal mining regions of West Virginia, Pennsylvania, eastern Kentucky and southern Illinois; the iron-range country of northern Minnesota and upper Michigan; the textile mill centers of New England; and the automobile manufacturing centers of Michigan. Since the end of World War II, the level of unemployment in many of these areas has increased sharply with each business recession, while showing little or no improvement with the return to national prosperity. In other depressed areas unemployment has dropped rapidly during prosperity periods, but has still remained quite high.

In the course of wide debate, economists and public policy makers have often overlooked the fact that depressed areas have been a recurring aspect of the economic development of this country. American history includes many accounts of the rise and fall of communities and whole regions owing to changes in technology, exploitation and exhaustion of natural resources, changes in demand and the migration of industry to other parts of the country in response to the pull of new markets—the same factors cited as contributing to chronic unemployment in today's depressed areas.

The term "ghost town," a standard part of our vocabulary, calls to mind the booming growth and sudden decline of gold and silver mining towns like Leadville, Central City and Cripple Creek, Colorado, and the logging and lumbering communities in Maine and the Lake states. Moreover, new depressed areas will probably continue to crop up in our changing and dynamic economy. As in the past they will most likely be characterized by a high degree of economic specialization, i.e., with one industry dominating virtually every phase of economic activity in the area.

No simple solution

The causes of chronic unemployment differ greatly from one depressed area to another. The experience of the past few years has shown that a high level of business activity in the nation as a whole has, at best, done no more than drain off some of the more mobile work force in such areas without significantly bettering the economic outlook for the depressed community itself. Unemployment has continued at relatively high levels in coal mining regions throughout most of the postwar period, and in the Detroit metropolitan area average annual unemployment has not dropped below 7 per cent of the labor force since the record auto output in 1955.

Unemployment in the mining regions of West Virginia, eastern Kentucky and southern Illinois has resulted from the loss of coal markets and the increased mechanization of mining operations to offset the effects of rising wages and other costs. The immediate prospects for increased employment in these regions are not good as alternative economic activities are quite limited. Moreover, relatively high wage rates and a long history of labor strife tend to discourage new industries from moving in.

Unemployment in the Detroit metropolitan area, on the other hand, primarily reflects the automobile industry's decentralization to supply rapidly growing markets in the southwestern and far western states and extensive automation of manufacturing operations to offset rising labor costs. In recent years the local unemployment problem has been intensified by the substantial shift in national defense emphasis from heavy conventional weapons to missiles and electronic equipment. In contrast to the coal mining regions, the present lack of economic diversification in the Detroit area probably is a less intractable problem in light of the diversified labor supply and the many community and industrial facilities in the area.

One-industry or highly specialized communities face drastic readjustment problems if demand for their product tapers off or shifts to alternative supply sources due to changes in technology or relative price considerations. While a more diversified community can "roll with the punch," gradually absorbing the displaced workers in other industries, this is a slower process in the one-industry towns. For them the initial problem is to attract other industries, and this can only be done by the promise of a better manufacturing environment than can be found elsewhere.

There is, of course, an inherent danger that some attempts at solving the problem may backfire and only prolong the process of readjustment as well as contribute to an inefficient allocation of the nation's resources. The latter could have unfavorable implications for domestic economic growth and our competitive position in international trade. Finally, there is the realization that the process of readjustment may take a long time. In this connection it may be noted that many communities which in the past have

had to adjust to economic change have never regained their former stature.

Lake states lumbering region
and principal sawmill centers, 1870-1900

The magnitude and complexity of the problems that chronically depressed areas face in attempting to reshape their economic base are aptly illustrated by developments in the former logging and sawmill communities in the lumbering region of the Lake states since the turn of the century. By the 1890's, many communities in the forest areas of Michigan, Minnesota and Wisconsin were confronted with the formidable task of adjusting to the decline of the lumbering industry which had dominated nearly every phase of their economic life.[1]

The lumbering era

After the Civil War the conquest of the vast pine forests of the Lake states began in earnest. Lumber production in the region grew rapidly from slightly more than 1 billion board feet in 1859 to a peak of nearly 10 billion board feet in 1889. In that year the Lake states accounted for 37 per cent of the nation's total lumber output. Communities like Grand Rapids, Bay City and Saginaw, Michigan; Minneapolis, Winona and Stillwater, Minnesota; Oshkosh, Chippewa Falls, La Crosse and Eau Claire, Wisconsin; which were strategically located on rivers, became booming sawmill centers.

Satellite industries, such as hardware and metalworking shops, foundries and machine shops as well as the typical assortment of service and retail trade establishments, sprang up in these communities to supply the needs of the logging camps and sawmills and the people engaged in lumbering. The larger communities supported gristmills, bakeries, canneries and meat-processing plants. But nearly every phase of the economic life of the lumbering towns in the Lake states was dependent in one way or another on the harvest of timber—a fact that became more and more ominous.

[1]Material for this article was largely drawn from the following sources: Franklin H. Smith, *A Study of the Wisconsin Wood-Using Industries* (Madison, 1910); Ray H. Whitbeck, *The Geography and Industries of Wisconsin* (Madison, 1913); Robert F. Freis, *Empire in Pine—The Story of Lumbering in Wisconsin 1830-1900* (Madison, 1950); Agnes M. Larson, *History of the White Pine Industry in Minnesota* (Minneapolis, 1949); Vernon Carstensen, *Farms or Forests* (Madison, 1958); Raleigh Barlowe, *Administration of Tax-Reverted Lands in the Lake States* (East Lansing, 1951); Maurice E. McGaugh, *The Settlement of the Saginaw Basin* (Chicago, 1950).

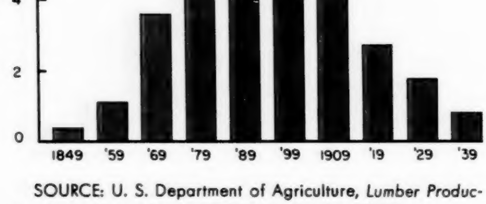
As early as 1866 the Commissioner of the U. S. General Land Office observed that the rapid destruction of timber in the Lake states was "a matter of serious concern." Many people in the logging communities, moreover, recognized that the rapid pace of activity could not go on forever and that decline was inevitable. In Wisconsin in 1897 it was estimated there was barely enough timber to sustain the lumber industry for another decade at current rates of production.

The lumbering industry reached a peak in Michigan during the 1880's and in the following decade Minnesota and Wisconsin attained their zenith in lumber output. Primarily reflecting exhaustion of the white pine forests, lumber production in the Lake states plummeted from 8.8 billion board feet in 1899 to 5.5 billion in 1909 and 2.7 billion in 1919.

As the production of lumber declined, population growth in logging regions leveled off. The population of the Michigan-Saginaw basin (an area of roughly 11,000 square miles surrounding the shores of Saginaw Bay) which had risen from 173,000 in 1860 to 507,000 in 1880, or nearly threefold, increased only 27 per cent during the next two decades. Ashland County in northern Wisconsin, where population had increased from 1,600 in 1880 to 20,100 in 1890, reported an increase of only 10 per cent between 1890 and 1910.

During this period a number of sawmill towns reported substantial population losses. For example, the population of Au Sable, Michigan, situated on the shore of Lake Huron at the mouth of the Au Sable River, declined from 4,300 in 1890 to less than 700 in 1910. Ashland, Wisconsin, dropped from 13,100 in 1900 to 11,600 in 1910. The Wisconsin State Forestry Commission observed in 1898: "Everybody has seen settlements very prosperous ten years ago, which are now abandoned by almost all their former inhabitants."

Lumber production in the Lake states reached peak around 1890



SOURCE: U. S. Department of Agriculture, *Lumber Production in the United States 1797-1946* (October 1948).

Diversification helps absorb slack

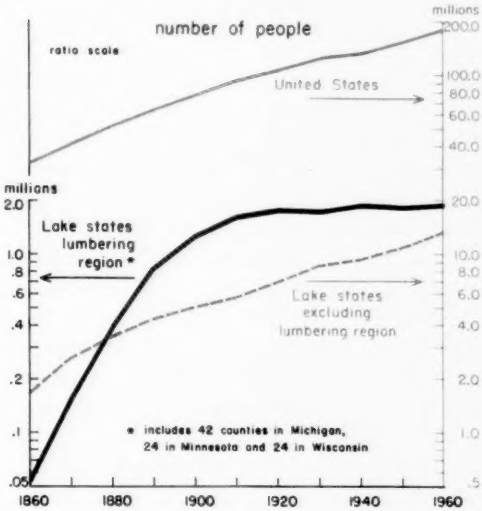
Many other sawmill towns, however, were quite successful in weathering the decline. For some, this reflected the fruits of vigorous campaigns to attract new industries. La Crosse, Wisconsin, which had begun its drive to attract new industries as early as 1855, boasted 13 flourishing industries in 1900. Among the more prominent were brewing, publishing, furniture, agricultural implements and machine shop products. Their growth helped materially to offset the impact of a more than 50 per cent decline in lumber output on the La Crosse economy during the 1890's.

In a number of other communities increased production of hardwoods, spruce

and hemlock and the expansion of wood-products manufacturing helped to absorb some of the slack caused by the sharp decline in the cut of white pine lumber. One observer described the situation as the "evolution of an industry in response to diminishing or changing raw materials."

Oshkosh and Saginaw became important manufacturers of lathes, sashes, doors, blinds, carriages and wagons. During the 1890's Oshkosh was reported to be the nation's leading producer of these items. In Grand Rapids the manufacture of chairs, tables and office equipment was expanded vigorously, and by the end of the 19th century that community had become the furniture capital of the country. Other communities concentrated on the production of shingles, barrels and cheese boxes, rail ties, matches, wood pulp, excelsior, coffins and boats. A study of Wisconsin industries done in 1910 noted that almost "every town of any size in the northern half of Wisconsin finds its industrial life centered around woodworking."

Population profile of Lake states lumbering region, 1860-1960



Farming, an answer?

Industrial diversification and expansion of wood products manufacturing are only part of the story of the vast economic readjustment that occurred in the lumbering region of the Lake states. The other part concerns the intense effort to find more productive uses for the vast tracts of stump land that blanketed the area.

There was, however, no clear agreement on how to go about redeveloping the land. Conservationists said the land should be restocked with trees. The railroads, lumber companies and local businessmen wanted the land made into farms to encourage agricultural settlement.

The state governments seemed to favor both approaches. In 1895 the Wisconsin legislature created a state immigration board to promote settlement of the northern counties; two years later it established a state forestry commission "to protect and utilize" the state's forest resources. The forestry commission was highly skeptical of the agricultural potential of the northern stump lands. They would produce only "crippled aspen . . . coarse grass and sweet fern." The state college of agriculture, on the other hand, felt the land could be made into productive farms and set out to prove it.

With the sharp rise in prices of food and farm land during World War I and the accompanying desire to provide farms for returning veterans, enthusiasm for conservation and reforestation was swept aside and the promoters of agricultural settlement rose to dominate the picture. In 1919 many believed the northern stump lands of the Lake states

were destined for a prosperous future as a farming area.

New problems emerge

Less than three years later, however, the farming experiment was clearly on the verge of collapse. Among the major contributing factors were the sharp drop in agricultural commodity prices following the cessation of World War I and the loss of local agricultural markets associated with the steady contraction of logging and sawmill operations. The price of eggs dropped from a national average of 42 cents a dozen in 1920 to 24 cents in 1922; during the same period the price of butter fell from 55 cents a pound to 36 cents. In 1921 corn sold for an average of 49 cents a bushel, compared with $1.45 in 1919.

In the face of these developments, the flow of new settlers into the northern counties dried up, land clearing and farm development ceased and farm land values dropped sharply. Tax delinquencies, which had been a continuing problem in the cutover regions, soared as farmers, lumber companies and speculators who had amassed vast tracts of land for resale at a profit stopped paying taxes on their nonmarketable stump lands. In 1921 tax deeds on approximately 1 million acres of tax-delinquent land in 17 northern Wisconsin counties, having a total area of roughly 11 million acres, were put up for sale by the local authorities; in 1928, 3 million acres were auctioned off. By the late 1920's many cutover counties in the Lake states reported that as much as 50 per cent of their lands were tax delinquent.

Buyer participation in the tax auctions was poor; speculation in tax certificates was practically nonexistent. In 1921 roughly 40 per cent of the land offered for taxes in 17 northern Wisconsin counties went unsold with the tax titles reverting to the counties; in 1927, 80 per cent of the land offered at tax auction reverted to the counties.

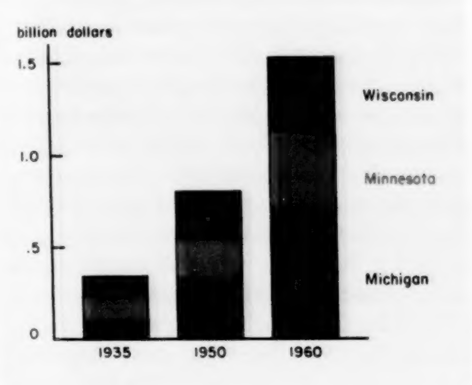
Despite the unfavorable prospects for agriculture in the Lake states lumbering region, farming activity picked up sharply between 1930 and 1935. During this period the number of farms in the region jumped 21 per cent to more than offset the decline of nearly 9 per cent that occurred during 1925-30. The number of farms in the nation as a whole increased approximately 8 per cent during 1930-35.

In large measure, this resurgence in farming activity across the land reflected the severe curtailment of employment opportunities in the cities during the depression. Widespread urban unemployment not only checked the well-established drift of farm people to the city but also prompted many hard-pressed urban families to move to the country and try to make a go of farming. Moreover, severe drought conditions on the Great Plains prompted many farmers in that area to relocate in the cutover region of the Lake states.

After 1935 the Lake states in cooperation with the Federal Resettlement Administration worked out procedures for relocating the isolated inhabitants in the cutover counties and for retiring marginal farm lands. The Federal and state governments stepped up their land purchases for the purpose of creating forest preserves and wild life refuges. In Wisconsin much of the tax-delinquent land that had reverted to the counties was used to establish county forests.

Reflecting the impact of these programs, approximately 30 million acres in Michigan, Minnesota and Wisconsin are under public ownership today—representing about 25 per cent of the total land area of these states. Roughly 90 per cent of these public lands is located in the northern cutover counties.

Tourist expenditures in the Lake states exceeded $1.5 billion in 1960



SOURCES: Curtis Publishing Co., *Recreation and Travel Report* (August 1960); National Resources Board, *Regional Planning Surveys* (1934 and 1935).

Moreover, the number of farms in the region has declined nearly 50 per cent since 1935.

Impact of the tourist industry

Aggressive promotion of the long-recognized recreational potentialities of the northland lakes, streams and forests has also figured importantly in the readjustment process. Since the 1930's the state legislatures have appropriated sizable funds to advertise resorts, camping, hunting and fishing opportunities in the state forests and other tourist attractions. Railroads and local chambers of commerce have also joined in the promotion of the northern vacationland. The construction and improvement of state and Federal highways have made the area increasingly accessible.

With the steady rise in national prosperity and increase in leisure since the end of World War II, thousands of city dwellers began to make annual treks to the North Woods to seek relaxation in such pursuits as camping, fishing, boating and sightseeing. Total tourist expenditures for transportation, lodging, equipment, hunting and fishing licenses, etc., in Michigan, Minnesota and Wisconsin have increased from less than 400 million dollars in 1935 to 800 million in 1950 and 1.5 billion in 1960. Today the job of providing goods and services to the horde of summer vacationers and sportsmen is the principal industry in many northern counties of the Lake states. To an increasing extent the area is offering year-round employment as winter sports grow in popularity. Many believe the recreation industry will grow twice as fast as the national economy during the next decade.

Conclusion

Thus, the experience of economic readjustment to the decline of the lumbering industry in the northern counties of the Lake states has emphasized that solutions to the problem of depressed areas are likely to be complex and extend over a considerable period of time. At the end of the 19th century, communities in the region faced the difficult task of developing new industries to offset the steady decline in lumber production. In many respects their situation was similar to a nation faced with overcoming recurring deficits in its international trade attributable to a decline in its primary exports.

Many northern communities managed to sustain the equivalent of their former export earnings by expanding production of doors, sashes, shingles and other wood products. In a number of other towns foundries, machine shops and metalworking shops that had been primarily engaged in supplying the needs of the logging camps and sawmills shifted to servicing manufacturers located in

other parts of the country. Promotion of the recreational opportunities of the northern lakes, streams and forests provided another important source of income for many communities in the area—the tourist industry.

In those communities where the development of new export industries did not proceed at a fast enough pace substantial depopulation occurred. This, however, helped to restore equilibrium to the region by reducing import demand.

The experience of these communities has further emphasized that there is always the risk that some attempts to solve the problem of depressed areas may not work at all and may only complicate and delay the adjustment process. Witness the collapse of the campaign to promote farming on the cutover lands despite vigorous backing from the state governments, the railroads, lumber companies, local businessmen and even "experts" from the agricultural colleges.

In recent years organized efforts have been made in a number of states to promote new kinds of economic activity to provide relief to pockets of prolonged unemployment. Now these efforts are being bolstered by a nationwide program of Federal loans and grants to depressed areas. If the story of economic readjustment in the Lake states lumbering region during the last half century is any guide, success of these efforts will largely depend upon the extent to which local resources, including raw materials, plant and labor, can be channeled into new "export-earning" activities without resulting in what time reveals to have been an inefficient allocation of resources. It is possible that some depressed communities will find that a significant portion of their existing labor force cannot be absorbed in new lines of activity. Here a successful readjustment will require substantial migration of workers from these communities to areas where jobs are available.

"Fannie Mae" and credit policy

The Federal National Mortgage Association (FNMA or "Fannie Mae") is one of a number of Federal credit agencies organized to influence the availability of credit to certain types of borrowers. Each of these agencies has been created in response to specific problems. Usually the purpose has been to increase the flow of credit to certain users or to reduce its cost. Sometimes it has been simply to stabilize the flow of the particular kind of credit against increasing cost and varying availability.

Whatever their form or objectives, the agencies have appeared from time to time to be operating somewhat contrary to general countercyclical policies designed to achieve growth and stability. This, of course, is not necessarily inappropriate since, as noted above, the Government-sponsored institutions have been organized in response to specific problems and their objectives may have a very high priority. Nevertheless, if the specialized agencies' programs can be managed in such a way as to fortify or at least not counteract general economic policy, they may make a positive contribution to achieve-

ment of the nation's prime economic goals.

FNMA activities

An important part of FNMA's responsibility has been the operation of a "secondary market facility" for FHA-insured and VA-guaranteed mortgages. The purpose is to provide a greater degree of liquidity to the market for these mortgages by standing ready to both buy and sell them. This tends to increase the liquidity of the portfolios of financial institutions who are active in the mortgage markets.

A second major phase of Fannie Mae's activity has been the provision of "special assistance" to types of Government-supported mortgages for which private financial facilities are judged inadequate. These have been mortgage loans on housing in urban renewal areas, homes for military personnel and for the elderly and "specialized" housing of other types.

The third major function since reorganization in 1954 has been the "liquidation and management" of mortgages acquired in prior years.

In February the Administration indicated that the resources of FNMA would be mobilized in the effort to reduce mortgage interest rates. It was hoped that lower interest rates would help to stimulate residential construction and speed the economy's recovery from recession.

To accomplish this, FNMA has raised its buying prices on mortgages several times and cut in half the amount of FNMA capital stock which must be bought by institutions selling mortgages to it. These moves were for the purpose of encouraging holders of mortgages to sell at a profit from their existing portfolios and use the proceeds for new mortgages. FNMA also raised selling prices on mortgages in its portfolio so as to restrict sales and, hence, avoid absorbing funds from lenders that otherwise might find their way into new mortgage loans and new construction. The price increases, of course, reduced

Functions of the Federal National Mortgage Association under the Charter Act of 1954

Secondary market operations

Provides a secondary market for government-supported mortgages.

Financed by common stock issues to institutions selling mortgages to FNMA, preferred stock issues to the Treasury and borrowings from the Treasury and private investors.

Special assistance functions

Provides assistance to classes of Government-supported mortgages that are inadequately provided for by private financial facilities.

Can be employed to bolster activity in mortgage and construction markets when reduced activity in those markets threatens a high level of national economic activity.

Financed by borrowings from the Treasury.

Management and liquidating functions

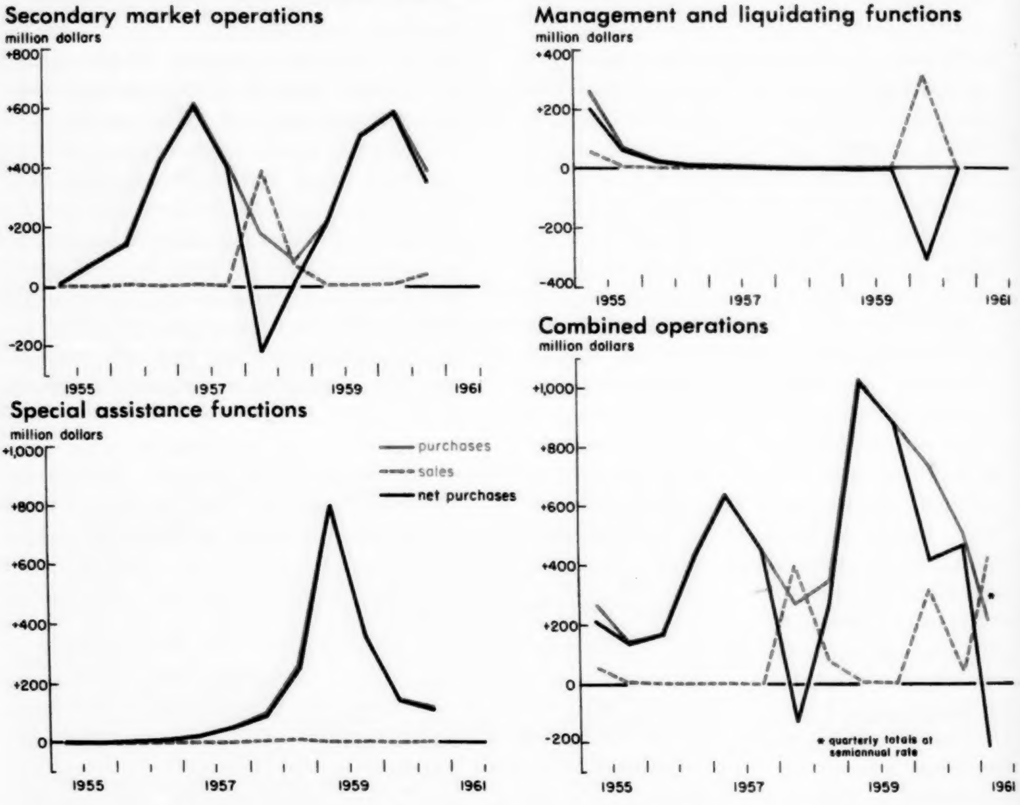
Manages and liquidates the portfolio acquired under contracts entered into prior to November 1, 1954.

Handles mortgages acquired subsequent to that date when specially authorized to do so.

Financed by borrowings from the Treasury and private investors.

FNMA mortgage sales exceeded purchases in 1958 and 1961

operations by type of function, semiannually



the yield that investors could obtain on mortgages purchased from FNMA.

Purchases at par

In the early postwar years as market interest rates rose relative to the maximum contract rates permitted under the Government-supported FHA and VA mortgage programs, the supply of private mortgage funds seeking investment in FHA and VA mortgages declined. Normally this would have caused a reduction in residential financing under the Government-supported programs. However, from the end of 1947 through March 1950, FNMA channeled funds into the Government-supported programs by purchasing mortgages at par, and entering into advance commitments to purchase at par, mortgages originating under these programs. During this period, the association's holdings of mortgages increased from less than 2 million dollars to nearly a billion dollars. By the end of March 1950, moreover, undisbursed commitments to pur-

chase mortgages stood at almost 1.5 billion dollars.

In effect, FNMA was "insulating" the market for Government-supported mortgages from the impact of rising rates by "pegging" such mortgages at par, thus holding interest costs to FHA and VA mortgage borrowers below market levels. The only effective restraint on the association's ability to do this was its authorization to borrow the funds needed to finance its mortgage acquisitions, and this authorization was increased each time the ceiling was reached.

FNMA borrowing authority
(millions of dollars)

February 1938 - July 1948	$ 220
July 1948 - July 1949	840
July 1949 - October 1949	1,500
October 1949 - April 1950	2,500
April 1950 - July 1952	2,750
July 1952 - August 1954	3,650

The FNMA Charter Act

Following adoption of the Charter Act of 1954, FNMA underwent a major reorganization. However, many observers assert that FNMA's activities continue to insulate the market for Government-supported mortgages from general credit conditions. They cite the fact that the association's net purchases of mortgages have expanded during periods of general credit restraint (1955-57 and 1959) and declined during periods of general credit ease (1954, 1958 and 1960-61).

However, the insulation FNMA has provided in recent years has been significantly different from that of the 1948-50 period. The big difference is that FNMA's *secondary market operations* no longer provide funds to the mortgage market at effective interest rates below those at which it obtains them through borrowing in the market. The association is no longer required to make purchases at par. Under its secondary market operations, it must regulate the volume of purchases and sales and the establishment of prices and fees so as to prevent "excessive" use of the facility and make it self-supporting. Purchases are made within the range of prices quoted in the market for similar mortgages.

Indeed, during some periods of credit restraint, and tightness in mortgage markets, effective interest rates on mortgages purchased by FNMA appear to have risen above those at which new loans were being originated as, for example, in late 1957 and late 1959. This lessened the attractiveness of FNMA as a source of funds for mortgage lending and tended to prevent "excessive" purchases from investors in periods in which mortgage funds and credit in general were in short supply.

The association has also related its selling prices on mortgages to prices in the market. This reflects the injunction to FNMA to be self-supporting. In 1958 and 1961, it reflected in addition the effort to harmonize FNMA's activities with prevailing general stabilization and credit policy.

The low-cost housing program of 1958 and 1959 has been an important activity under Fannie Mae's *special assistance* operations. The 1958 Act to Stimulate Residential Construction authorized a 1 billion dollar purchase program for home mortgages of $13,500 or less.

From the inception of the program through August 28, 1958, FNMA made advance commitments at par. This gave borrowers an effective interest cost somewhat under rates in the private market, especially in the case of VA loans. Commitments rose rapidly. By October 1958, purchases and outstanding commitments had reached the 1 billion dollar statutory ceiling. Purchases under the pro-

gram reached a peak in the first half of 1959 when business activity was rising rapidly. However, expenditures for construction presumably preceded Fannie Mae's disbursement of funds by some months and most of its purchases were completed prior to the emergence of active credit restraint in the second half of 1959.

Operations carried on under the *management and liquidating* function have also affected the availability of funds in mortgage markets—at times significantly. This was the case in 1955, for example, when net purchases totaling 264 million dollars provided the market for Government-supported mortgages with a buffer against general credit restraint.

Management and liquidating functions were also a significant factor in 1960. During the first half of the year, FNMA exchanged 311 million dollars in 4 per cent VA mortgages for 2¾ per cent Treasury bonds. These operations were equivalent to mortgage sales in terms of absorbing funds from the private mortgage market. The exchanges tended to cushion the mortgage market against general credit ease, which was becoming evident in early 1960.

Combined operations: 1955-61

Since its reorganization in 1954, FNMA has pursued its program of mortgage acquisition and sale with an eye to the requirements of over-all credit policy. During periods of over-all credit restraint, there has been no attempt to "peg" Government-supported mortgages at prices above the market. And during periods of general credit ease, sales prices have been raised to levels designed to curtail purchases from the FNMA portfolio by investors.

Moreover, general credit policy is concerned with the total supply of credit. The allocation of this supply among competing uses is determined largely by the market on the basis of relative prices or yields. FNMA's secondary market operations have been conducted within this framework. The association has not provided funds to the mortgage market at interest rates below those available in the money and capital markets, and it has not made a practice of absorbing funds from the market through mortgage sales at a loss. The secondary market program has been consistently self-supporting. However, FNMA has been able to provide a degree of insulation to the mortgage market while remaining self-supporting, largely because of its credit standing as a Federal agency. While the association's debentures are not guaranteed by the Treasury, they are received by the market at rates considerably lower than those available to private borrowers.

The record since 1954 indicates that while the objectives of FNMA, and other specialized Federal credit agencies, may occasionally be in discord with those of over-all economic policy, under most circumstances these agencies should be able to achieve their specific goals reasonably well without coming unduly into conflict with broader economic objectives.

Business Conditions *is published monthly by the* FEDERAL RESERVE BANK OF CHICAGO. *Subscriptions are available to the public without charge. For information concerning bulk mailings to banks, business organizations and educational institutions, write: Research Department, Federal Reserve Bank of Chicago, Box 834, Chicago 90, Illinois. Articles may be reprinted provided source is credited.*